

CONTRACTS + RISKS + MANAGEMENT = CONTRACTUAL RISK MANAGEMENT?

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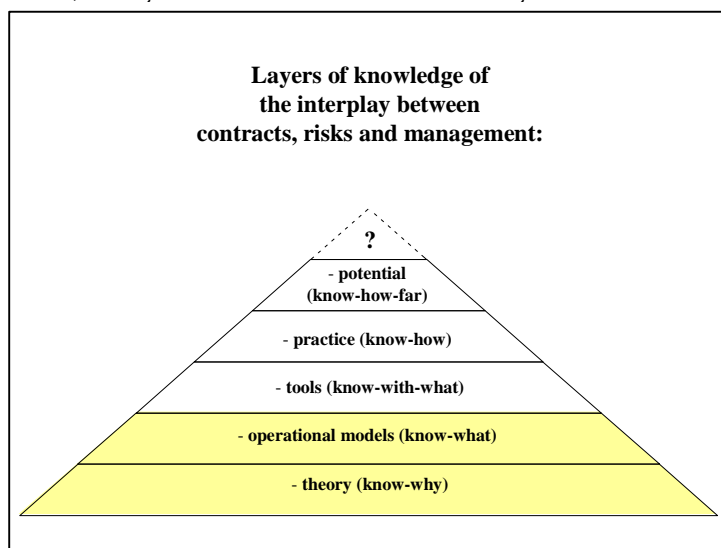
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Proactive contracting and risk management have become an important part of the new vocabulary of commercial contract law books and courses for contracting professionals, for example in Finland, during the past few years. More and more often one even stumbles over the term “contractual risk management” in such material but very seldom does one find a definition of that term. I claim that the lack of definition(s) of this term in most of the current literature dealing with this subject is due to varying conceptualizations of the underlying interplay between contracts, risks and management. Therefore, the goal of this paper is to discuss the different conceptualizations of that interplay. I will also present my prediction over the future development within the field of contractual risk management and my model for the governance of such future.

However, before we set on our journey I would like to help the readers of this paper to place the discussion in this paper in the context of the different types of knowledge concerning the interplay between contracts, risks and management. This can be done through a visualization of the underlying multilayered structure of knowledge on this matter with the help of an illustration of the different layers of knowledge. Such knowledge can namely be visualized as a pyramid, where the different layers support and guide one another. Due to the practical nature of their work, many of the readers are most likely familiar with the pragmatic layers of knowledge of the



interplay between contracts, risks and management. Such pragmatic layers of knowledge focus on the practical knowledge, practices, tools and skills of contracting professionals. Accordingly, such pragmatic layers focus on the questions of *how* and *with what* to manage the everyday interplay between contracts, risks and management. More experienced contracting professional have in addition developed knowledge on the limits and potential of this interplay and therefore understand

how far the practices and tools for the management of this interplay can be driven. Nevertheless, such pragmatic knowledge can be better understood, enhanced and developed with the help of a more theoretical and fundamental layer of knowledge that focus on the question of *what* the interplay between contracts, risks and management is really about and what alternative ways (models) we have for the governance of that interplay. An even more theoretical layer of knowledge explains the reasons *why* the interplay between contracts, risks and management is so important in the world of today; explains why this interplay is conceptualized in so many different ways by those who work within the field of contracts, risks and management; and last

but not the least, enables us to look for new ways of conceptualizing the interplay between contracts, risks and management.

Although knowledge of all these different layers will enhance our understanding of the true nature of the interplay between contracts, risks and management, people working with the pragmatic perspectives to such interplay do not need to master all layers of knowledge, e.g. the theoretical foundations of their work. They should however be familiar with the *why* and *what*-questions in order to better understand the *with-what* and *how*-questions, and in order to fully realize the potential in the interplay. Similarly, those who work with the theoretical layers of knowledge need to be familiar with the *with-what* and *how*-questions in order to be able to develop adequate theoretical explanations and models of this contracting phenomena. On the other hand, the theoretical knowledge might provide a shortcut to creative solutions for the governance of the interplay between contracts, risks and management since a theoretical approach to the issue intends to identify the underlying mechanisms of the interplay, below the casuistic surface of practices within the field of the of contracts, risks and management.

As the illustration of the pyramid of knowledge on the interplay between contracts, risks and management suggests, this paper will mainly focus on the two elementary layers of knowledge, the theoretical knowledge based on the *why* and *what* questions. The more pragmatic layers of knowledge are the subject of majority of the existing contracting literature. The mutual understanding between these theoretical and pragmatic approaches is the basis for the understanding of the underlying potential in the interplay between contracts, risks and management. Such a potential can namely be fully realized with the help of an *adequately* multilayered knowledge of the interplay. In this paper, I will show one possible direction for the development of such a mutual understanding, which hopefully will help the readers to develop their own understanding of the interplay between contracts, risks and management.

Nevertheless, there is yet another layer of knowledge that I have placed at the very top of the pyramid. This layer is quite essential for a successful application of the knowledge on the interplay between contracts, risks and management but it has less to do with pure knowledge or skills. Without this layer, the knowledge on the interplay will lack the cutting edge that is needed in the successful implementation of such knowledge in the governance of the contracts, risks and management of an organization. However, I will let the content of this layer puzzle the mind of the reader and will not reveal it until the very end of this paper.

1 Contracts and risks?

The fact that contracts and risks are intertwined is hard to escape. The inescapable truth of decision making in today's world is that it is all about risks and risk management. This perspective of the human decisionmaking has been a subject of a substantial amount of literature within the social sciences but has only to a small degree been reflected in the legal literature.¹ This cultural difference is mainly due to differences in language, law and lawyers have not been familiar with the risk terminology and have often communicated the same type of reasoning through the concepts of prevention: prevention of accidents, conflicts, litigation

¹ See Keskitalo, Petri, *From Assumptions to Risk Management*, Kauppakaari, Helsinki 2000, chapter II, for a discussion on the evolution of a risk oriented conception of the phenomena of changing circumstances within contract law.

etc. The essential point therefore is to realize that risk management as a particular type of reasoning is hardly totally new to law although lawyers are less familiar with the terminology and methodology that lies behind the risk management discipline.

Nevertheless, the relationship between contracts and risks can be approached from quite different directions. Depending on the chosen approach to contracts and risks, the relationship between them will be viewed quite differently. If one chooses to approach contracts and the contracting activity of businesses and other organizations from the perspective of *legal risks*, contracts will most likely be viewed as sources of risks since contracts in such an approach are easily understood as primarily legal instruments. This perception of contracts as sources of risks is shared by the more analytic perspective of *liability risks* since contracts create contractual relationships loaded with rights and liabilities. On the other hand, if one chooses to approach contracts from the concept of *contract risks*, the focus shifts towards the details of contracts in order to deal with the risks that these contracts are embedded with. Finally, if one approaches contracts from the perspective of *business risks* and sees the contracting activity as yet another branch of the organizations activities, contracts are no longer conceptualized merely as sources of risks but also as tools for the management of not only contract, liability of legal risks but also business risks.

Contracts can be tools for risk management and that applies to all types of contracts: business-to-business contract (B2B), business-to-government contracts (B2G), business-to-consumer contracts (B2C), consumer-to-consumer contracts (C2C), as well as government to government contract (G2G). However, this risk management aspect of contracting is most appealing to the first two groups of contracts due to the importance of contractual regulation of the relationships between the parties in these two types of contracts. It is almost needless to say that not all contracts are tools for risk management; only *good contracts* fulfil that role while *bad contracts* are in fact risks as such. The interplay between contracts and risks has in other words to do with the art and discipline of *good contracting*. But what is good contracting and what are good contracts? In order to answer these questions one should take a detour and discuss the role of contracts in different forms of business management.

2 Contracts and management?

What is then the relationship between contracts and management? What is management? Due to the novelty of the concept of management in a contract law setting we need to clear out its various definitions, as well as the definitions of other related concepts such as control, compliance, administration and governance and their relationship to contracts.

2.1 Contracts and control

We start with the relationship between contracts and control. The concept of *control* has been on the foreground of contract legal vocabulary of Nordic lawyers ever since the introduction of the new type of liability through the enactment of the “new” Sale of Goods Acts in Finland, Norway and Sweden during the 1980’s and early 1990’s while keeping the liability rule of the Art. 79 of the UN Convention on the International Sale of Goods (CISG) as their model. This new type of liability has later on been described as the so called “control liability” in Nordic legal literature. It is precisely the choice of the term “control liability” that shows the problems that lawyers have in conceptualizing management. The so called “control liability” has namely

only little to do with actual control, which normally is linked to the possibility of using power to sort things out. In fact, this new type of liability is more appropriately conceptualized as a particular type of *risk management liability* as I have argued in my book *From Assumptions to Risk Management*.² Considering the fact that the wording of those provisions specifically points out liability even for certain types of impediments beyond control,³ it is in fact quite peculiar that the term “control liability” was chosen to describe this new rule of liability and even more peculiar that the term has later on become the accepted vocabulary of lawyers throughout the northern Nordic countries. The concept of control offers a very narrow approach to the conceptualization of the role of contracts in the management of organizations.

2.2 Contracts and compliance

Another modern concept is that of *compliance*. Compliance refers to the alignment of the organizations activities according to the legal regulation of such activities. Compliance has become an increasingly important part of the management of organizations particularly in those countries where the legal order gives positive incentives for such proactive alignment. For example, according to the Organizational Sentencing Guidelines of the U.S. Sentencing Commission, introduced in 1991 and last amended in November 2004, dramatically less severe fines for breaches against their legal duties are imposed against those U.S. organizations that have effective⁴ *compliance programs*.⁵ The definition of the concept of compliance resembles thereby the concept of due diligence, both concepts underlining the importance of diligent conduct of the persons responsible for organization’s activities. Although the design and management of the compliance program of an organization has strong resemblance with the concept of management, the concept of compliance as such has little resemblance with the concept of management. But the concept of compliance does not only refer to compliance with legislation, it can also refer to compliance with contractual obligations i.e. *contract compliance*. Contract compliance offers a slightly broader approach than the concept of control to the conceptualization of the interplay between contracts, risks and management but is far too narrow in order to realize the potential role of contracts in the management of organizations.

² Keskitalo, Petri, *From Assumptions to Risk Management*, Kauppakaari, Helsinki 2000, pp. 233-269.

³ This applies to impediments which themselves or their consequences – although being beyond control of the party in breach or his/hers subcontractors – could have been foreseen and/or to impediments which themselves or their consequences could have been avoided or overcome by the party in breach or by his/hers subcontractors.

⁴ The effectiveness of the organizations compliance programs is determined by the seven points minimum criteria defined by the §8B2.1. of the Organizational Sentencing Guidelines, that is available at http://www.ussc.gov/2004guid/8b2_1.htm.

⁵ These guidelines and information about the effect of efficient compliance programs are available at <http://www.ussc.gov/orgguide.HTM>. For an introduction to the role and history of the Sentencing Committee and its guidelines as well as the practice concerning the impact of effective compliance programs see Murphy, Diane E., *The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, Iowa Law Review 2002, p. 697-719, available at <http://www.ussc.gov/corp/Murphy1.pdf>. The last amendment of November 1, 2004 was due to the Sarbanes-Oxley Act section 805 (a)(2)(5) as explained in the 2004 Federal Sentencing Guideline Manual, Appendix C – 2004 Supplement, available at <http://www.ussc.gov/2004guid/APPC-2004SUPP.pdf>.

2.3 *Contracts and administration*

Another concept that is likely to receive attention in future contract law literature is that of *administration*. The reason for this is the increasing importance of effective administration/management of the portfolio of contracts that organizations have. *Contract administration* is a very popular concept within the public sector contracting in United States. Somewhat surprisingly this concept seems not to have had an established definition in the past. However, the majority of recent contracting literature seems to define contract administration as the processes dealing with the implementation of contracts after they have been created.⁶ Although this conception of the role of contracts is broader than the compliance oriented approach, it is still a rather narrow conception of the potential and role of contracts in management of organizations.

2.4 *Contracts and management*

Now we have finally come to the very central concept of *management*. This concept is naturally quite central due to the fundamental concept of *business management*. Although this concept is often used as a synonym to business administration, it seems that the latter concept is seen less fashionable and is increasingly being used to address the work of lower level business executives, while the concept of business management is being used to address the work of top level business executives. Regardless, the concept of business management has led to the rise of several more narrow concepts describing different areas of business management such as Supplier Relationship Management (SRM) and Customer Relationship Management (CRM). The concept of *risk management* is another such concept. Although there is no consensus on a standard definition of the concept of risk management, which will be discussed in detail under chapter 3, there is a certain consensus that risk management refers to the processes that are directed towards the management of potential opportunities and the connected potential for adverse effects. The concept of *project management* is yet another related concept that refers to the processes to manage a particular project to meet its requirements. Project management discipline is thereby a broader concept and can include for example risk management aspects of the project.

Within the world of contracting, the concept of management has gained a lot of attention through the concept of *contract management* which is closely related to the concept of contract administration and they have often been used synonymously. However, in the majority of recent contracting literature the concept of contract management refers to the processes of contract lifecycle management, rather than the management of implementation of contracts, which is the focus of contract administration. Contract management offers an important perspective to the conceptualization of the role of contracts in the management of organizations, although it has challenges in fully realizing the potential role of contracts due to its focus on single contracts or transactions, rather than the entire contracting activity of the organization. The introduction of the broader *enterprise contract management* perspective, which will be discussed under chapter 4.3., will eventually help to develop the contract management perspective in a way that that will enable it to overcome this disadvantage.

⁶ Similarly Haapio, Helena, *Tarjous- ja sopimussuunnittelu teollisuuden toimitusprojektien tukena*, in Haapio, Helena, et.al., *Yritysten sopimus- ja vastuuketjut*, Tietosanoma, Helsinki 2005, pp. 330-331.

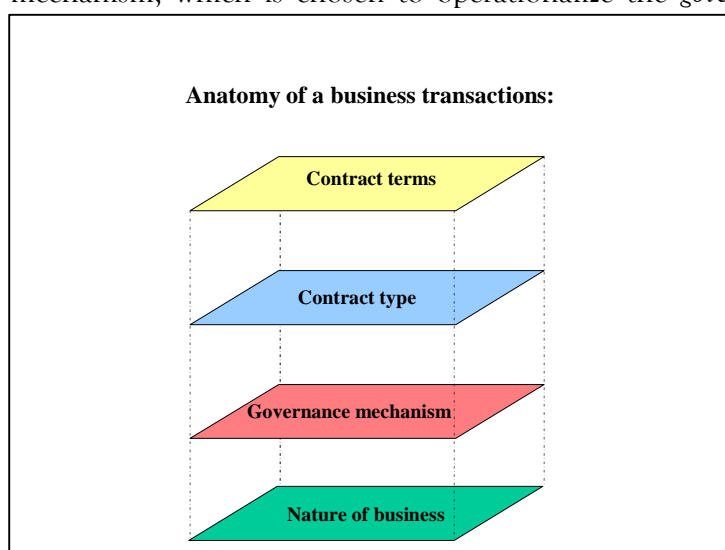
2.5 Contracts and governance

The next but by far the least important perspective in the conceptualization of the relationship between contracts and management is the concept of *governance*. Particularly the rapid rise of *corporate governance* to the forefront of the business vocabulary has brought this concept to the awareness of lawyers. Corporate governance has gained a central role in the regulation of businesses throughout the world in the aftermath of a series of relatively recent business scandals in several countries.⁷ However, corporate governance as a discipline has existed already since the early 1990's but was not given due attention to before the most recent corporate scandals. Accordingly, corporate governance has recently been given a central role in the regulation of business even in most of the Nordic countries. For example in Finland the companies that are listed in the Helsinki Stock Exchange are expected to comply with the Helsinki Stock Exchange recommendation for corporate governance.⁸ The underlying definition of governance in this context lies quite close to the concepts of administration and management although the focus is shifted towards the overarching governance of the corporation in order to assure the shareholders and the public of the compliance with certain standards of management in such corporations. We will discuss this perspective to governance under chapter 3.2.

However there is another perspective to the concept of governance that can be illustrated through the concept of *mechanisms of governance of business*. Unlike the previous concepts, this concept is first and foremost an academic concept that has been developed under the school of economics that is known as *Transactions Costs Economics*.⁹ The role of contracts in business governance can be illustrated through a multilayered approach to the structure of commercial transactions, which is developed on the basis of the integration of the Oliver E. Williamson's theory of mechanisms of governance and my own theory of contractual risk management as defined in my book *From Assumptions to Risk Management*. In this multilayered approach the contract documents and the *contract terms* are just the surface of the transactions. Under that surface lies the *contract type*, which stands for the chosen contractual risk management mechanism, which is chosen to operationalize the *governance mechanisms* that the business is

relying on, which in its turn is chosen to fit the *nature of the business*.

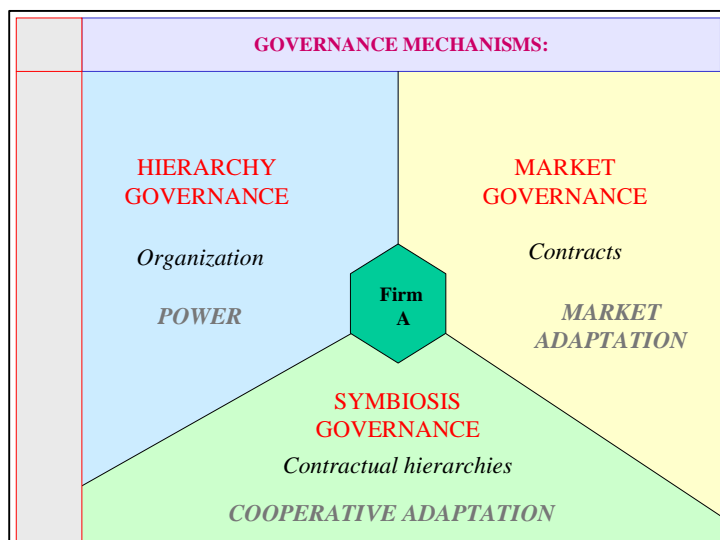
It is the *governance mechanisms* that form the key to the understanding of business governance and need to be discussed in detail. The following figure illustrates the basic features behind these alternative forms of governance mechanisms:



⁷ Consider the recent scandals of Enron, WorldCom and Tyco in U.S and Parmalat in Italy.

⁸ This comply or explain-recommendation for the publicly listed companies in Finland is available in in English at http://www.hex.com/files/4YqkTEfR/liite/CG_Group_Recommendation_engl_final1.pdf.

⁹ Excellent introduction to this school of economics is found in Ménard, Claude & Shirley, Mary M. (eds.), *Handbook of New Institutional Economics*, Springer, Dordrecht 2004.



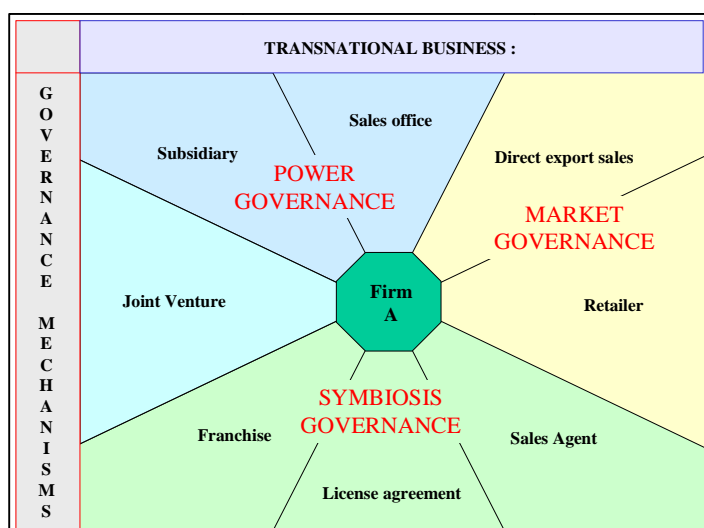
In the early literature on such mechanisms of governance, it was claimed that there were two alternative mechanisms: market governance and hierarchy governance. The *market governance* was based on the use of transactions through contracting, while the *hierarchy governance* was based on the use of the organizational power within the firm. In other words, the firms either contracted with other firms or took care of the transactions within the firm, a matter which has later been

crystallised as the question of make or buy.¹⁰ That dichotomy has been altered by the changes in the way that businesses operate, a development which that lead to the appearance and increasing popularity of a third type of governance mechanism: the *hybrid governance* that attempts to rely on the best features of the two original alternatives through the use of contractually created hierarchies. Whereas these hybrids were originally seen as temporary governance mechanisms on the way of development from markets to hierarchies or vice versa, they are today seen as a very important alternative governance mechanism.¹¹

It is particularly worth noting that the alternatives offer different means to the solution of the central economic problem for organizations: adaptation to market changes. Whereas the *hierarchy governance* relies on the use of power within the organization of the firm itself, the *market governance* relies on the capability of the market to adapt to the new situation. The *hybrid governance* relies on the cooperative adaptation by both of the contract parties according to the contractual hierarchies that the firms have chosen for the particular transaction, which is the

reason why I prefer to call this governance mechanism *symbiosis governance* since the firms are supposed to find a form of adaptation that is beneficial for both of the parties.

Those in charge of the firm's contracting activity must know the differences between the alternative mechanisms of governance and must be able to use them in a meaningful way through the use of compatible contract instruments, standard



¹⁰ See Rubin, Paul H., *Managing Business Transactions*, New York 1992.

¹¹ Whereas these hybrids were originally seen as temporary governance mechanisms on the way of development from markets to hierarchies or vice versa, they are today seen as a very important alternative governance mechanism. An excellent discussion of the role and key issues concerning such hybrids is found in Ménard, Claude, *A New Institutional Approach to Organization*, in Ménard, Claude & Shirley, Mary M. (eds.), *Handbook of New Institutional Economics*, Springer, Dordrecht 2004, pp. 281-318.

contract terms and other contracting standards and tailored contract clauses. I will shortly discuss the link between governance mechanisms and contracts with the help of examples from the governance of transnational business transactions.

Market governance is based on sales contracts between two independent firms either through direct sales between the seller and the buyer, or through a reseller. Market governance relies, as suggested by its name, on functional markets and does not necessarily aim towards a long-term business relationship between the firms. Thereby it does not presuppose the creation of a particularly strong trust between the contract parties. Use of the market governance-mechanism presupposes, however, that the contract parties are able to create a credible commitment with the help of their contract in order to enable the parties to make the necessary transaction specific investments. Aided by market governance, the seller can enter foreign markets fast but does not have much ability to manage the development of its own market share, except through marketing either by herself or through imposing such obligations to the reseller with the help of the resale contract. The greatest advantage of the market governance from the seller's point of view is the limited need for investments abroad.

Symbiosis governance is based on the already existing or through the contractual relationship evolving symbiotic business relationship.¹² Common contractual instruments for the symbiosis governance are agent, licensing, and franchise-contracts, and similar complicated contractual instruments, which rely on the reliance and trust that has been created or is evolving between the contract parties.¹³ With the help of the symbiosis governance the seller is able to manage the development of its foreign market shares better than with market governance since by binding the contracting party to a symbiotic contractual relationship the seller is able to use the interest and ability of his contracting party to develop the market through the know-how and investments of his contracting party. Thereby the seller will be able to minimize the need for his own investment to develop the foreign market. On the other hand, the seller is submitting himself to the dependability of the true capabilities and interests of his contracting party to achieve such goals. This dependability may turn out to be problematic, when the transaction that was believed to be symbiotic turns out to have only limited value to the business of his contract party. The central problem for the seller in symbiotic contracting is the eventual opportunistic behaviour of the contract party, particularly the so called free-rider problem, where the contract party is trying to exploit the investments of the other parties in the business arrangement, while minimizing his own investments. The central practical problem for the seller is therefore the control of the quality of the contract party's activity, for example the binding of royalties to clear sales targets in contracts with commercial agents. In licensing and franchising contracts this problem of the control of the quality concerns first and foremost the quality of the products or services that the contract party provides, in comparison with the general quality standards of the organization. Problems with quality of the operations of the contract party will affect even the reputation of the seller business and in global market environments they may affect the sellers business even in markets that are not the responsibility

¹² The term symbiosis governance is based on the term "symbiotic arrangements" that Schantze, Erich, *Beyond Contract and Corporation: The Law and Economics of Symbiotic Arrangements*, in Riis, Thomas & Nielsen Ruth (eds.), *Law and Economics. Methodology and Application*, DJØF Publishing, Copenhagen 1998, pp. 113-130, uses to describe complex contractual mechanisms, which do not under the market and hierarchy governance mechanisms.

¹³ Cf. Nystén-Haarala, Soili, *Kaukoviisas ennakoiva oikeusajattelu ja jälkiviisas tuomioistuinjuridiikka*; Pohjonen, Soile, *Sopimustoiminta, ajattelutavat ja muuttuva maailma*; and Taskinen, Tommi, *Sopimisen arvontuotanto verkostoituvalla tuotekehityshankkeelle* (2002) who all discuss such cooperation. All these articles which were published in Pohjonen (ed.), *Ennakoiva sopiminen*, WSOY Lakitieto, Helsinki 2002.

of the contract party. In franchise-contracts this problem is remedied through a highly detailed regulation of the business operations throughout the organization.¹⁴ Another problem for the seller in symbiosis governance is the risk of the contract party's opportunistic behaviour through the copying of the business concept. One instrument for the management of this risk is the joint venture contract, which relies on the use of both symbiosis and power governance. Through a joint venture contracts one tries to commit both contract parties to the operation of the joint venture company in a way that makes it less attractive to start out a competitive business operation with the joint venture.

Hierarchy governance relies on the use of power within the organization. Accordingly, it relies on instruments like joint venture contracts, the creation of fully owned subsidiaries or sales offices, either through acquisitions or start ups. Even most of these instruments are relying on specific contractual mechanisms and solutions.

The choice between these governance mechanisms, compatible contractual instruments and their fine-tuning are elementary challenges to businesses both in terms of outsourcing as well as in terms of expansion of the business. Contracts are in other words elementary instruments in the operationalization of the strategic decisions of the firm in terms of desired business governance mechanisms.

The concept of mechanisms of business governance offers an exiting potential for the development of our conceptualization of the interplay between contracts, risks and management since it links contracts to the core strategic decisions of businesses. Thereby the concept of business governance opens new development opportunities for conceptualization of the role of contracts both in relation to risks as well as management. I will describe one such new conceptualization at the end of this paper.

2.6 *Contracts and integrated Governance, Risk and Compliance Management (GRC)*

The most recent and most ambitious concept of management is the concept of integrated governance and risk and compliance management (GRC). The appearance of this concept is not surprising considering the close relationship between the disciplines of corporate governance, risk management and compliance management, which necessitates some form of coordination between them in order to facilitate effective cooperation between them. Not surprisingly, the eight annual global Price Waterhouse Coopers Corporate Executive Officer survey of 2005, focused on the conception of the integrated GRC in business companies, shows that the most effective way to coordinate these three disciplines is an integration of them into one integrated and embedded framework.¹⁵

Although the GRC-concept is rather new, there are few competing models for the conceptualization of such an integrated approach. Consider for example the PriceWaterhouseCoopers *The Governance, Risk & Compliance Operating Model*TM and the Committee of Sponsoring Organizations of the Treadway Commission's, COSO ERM -

¹⁴ See Nystén-Haarala, Soili, *ibid*.

¹⁵ See PriceWaterhouseCoopers, *8th Annual Global CEO Survey Bold Ambitions Careful Choices*, available at <http://www.pwc.com/extweb/insights.nsf/docid/48C44DA89CB0CC4185256F7F0061C641>, pp. 33-38.

Integrated Framework,¹⁶ which will be shortly discussed under chapter 3.2. While the PriceWaterhouseCoopers' *The Governance, Risk & Compliance Operating Model*TM emphasizes the role of ethics in such an integrated GRC by addressing the importance of an "integrity-driven performance strategy", the COSO ERM - *Integrated Framework* puts less emphasis on such issues.

Due to the complexity of such an integrated cooperation between governance, risk and compliance management, both of these models present a rather complex model for conceptualization of the GRC. This applies particularly to the PriceWaterhouseCoopers *The Governance, Risk & Compliance Operating Model*TM, which offers a highly complex model that sets rather high demands for the skills and motivation of the persons operating the model in organizations.¹⁷

Although, the conception of the role of contracts within GRC-discipline seems unclear for the time being, the GRC-concept offers a great potential for the development of the role of contracts in management of organizations. One conceptualization of the role of contracts in such an integrated framework of contracts, governance and risk and compliance management will be presented under the chapter 5.

3 Risk Management (RM)

As we already have touched upon the concept of risk management, it is time to explore it a bit further. Risk management is an area of business management that has received increasing attention in the literature on business management over the past decade.¹⁸ The practical importance of risk management to businesses is even greater and it forms an essential part of the business operations of today.¹⁹ The viability of a discipline is displayed in its ability to develop itself further; this has been easy for the risk management-discipline. One such important development is the introduction of the first international standard on the terminology of the risk management discipline by the International Organization for

¹⁶ The COSO ERM – *Integrated Framework* is presented in the *Executive Summary* of the Framework, which available at <http://www.coso.org/publications.htm>, where the model itself can also be ordered.

¹⁷ A presentation of this model is found in PriceWaterhouseCoopers, *Integrity-Driven Performance: A New Strategy for Success Through Integrated Governance, Risk and Compliance Management: A White Paper*, 2004, available at <http://www.pwc.com/extweb/service.nsf/docid/c8753369ed2d193e85256e1b001c03d6>.

¹⁸ Hamilton, Gustaf *Risk Management* 2000, Lund 1996, pp. 9-11 and Berg, Karl-Erik, *Yrityksen riskinhallinta*, Jyväskylä 1994, pp. 18-20, identify the roots of risk management in the self-insurance related discussion in United States in the mid 1930's, and Hamilton suggests that the concept of risk management was first introduced in the mid 1950's. The idea of risk management was imported into the Nordic countries in the mid 1970's, and the first textbook was published by Hamilton in 1977 with the title *Risk Management – vad är det?* As an example of the increasing attention, consider the ever increasing number of textbooks on risk management.

¹⁹ There are numerous signals of the increasing appreciation of the importance of risk management. For instance, one should notice the increasing number of consultant services available for risk management. In Finland, a remarkable project to promote risk management in small and medium-sized businesses has been organized and financed through the cooperation of the Ministry of Social Affairs and Health, the Ministry of Trade and Industry, the European Agency for Safety and Health at Work, and several other organizations, businesses and universities. The project has developed a package of devices for the purposes of risk management. It consists of both information and know-how. Information about the project is available on Internet at <http://www.pk-rh.com/en/index.html>, where the products of the project are available for free, both in English, Finnish, German and Swedish. The results of the originally Finnish project have been adopted to the UK and German environments by the Institution of Occupational Safety and Health (IOSH) respectively by Institut für Arbeitswissenschaft der Technischen Universität Darmstadt (IAD, TU Darmstadt).

Standardization (ISO) and the International Electrotechnical Commission (IEC).²⁰ According to the *ISO/IEC Guide 73:2002 Risk management – Vocabulary*, the term *risk management* refers to:

“and control an organization with regard to risk”,

whereas the term *risk* refers to:

“combination of the probability of an event and its consequences”.

This standardization eventually will help the risk management discipline to agree on the central terminology within this field. However, due to its focus on the risk management terminology, the actual content of risk management activities has not been addressed by this ISO/IEC standard and we need to look for answers elsewhere. Due to the continuous development of the risk management discipline, we need to identify three perspectives to the phenomena in order to better understand it: the past, the future, and the present state of risk management.

3.1 RM past

Traditionally risk management has been described as a management activity consisting of five phases:²¹

- target-setting for risk management,
- risk identification,
- risk evaluation,
- selecting methods for and estimating the costs of risk management, and
- developing a risk management system.

The goal of risk management according to this traditional approach is to ensure that the chosen solutions will fulfil the tasks that are assigned to them strategically in a way that economizes on costs and minimizes risks.²² Accordingly, risk management facilitates only a part of business management. The most important practical consequences of this limited scope of risk

²⁰ See the ISO/IEC, *Guide 73:2002 Risk management – Vocabulary*, International Organization for Standardization & International Electrotechnical Commission, Geneva 2002.

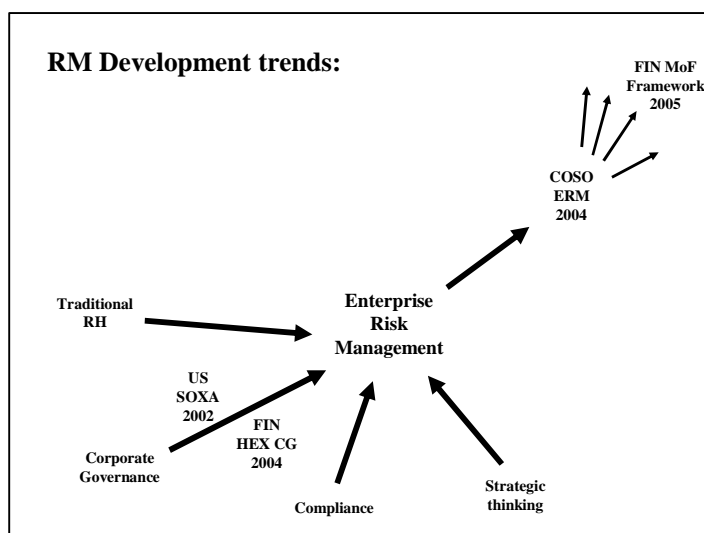
²¹ See Luotonen, Eero, *Risk Management and Insurances*, Helsinki 1993, pp. 20-27. Cf. Samson, Danny A., *Corporate Risk Philosophy for Improved Risk Management*, Journal of Business Research 1987, p. 109, who divides the risk management process into five phases: risk identification, risk measurement and analysis, risk control and finance, evaluation, and accounting the costs of risks. This division adopts a broader approach to risk management that is more compatible with a business management approach, and it is also used by Suominen, Arto, *Riskienhallinnan mahdollisuudet ja kehitysalueet*, in Kuusela, Hannu & Ollikainen, Reijo, *Riskit ja riskienhallinta*, Tampere University Press, Vammala 1999, p. 135. Even the division used by Smith, Robert J., *Allocation of Risk – The Case for Manageability*, International Construction Law Review 1996, pp. 566-568, cf. Robert J. Smith, *Risk Identification and Allocation: Saving Money by Improving Contracts and Contracting Practices*, International Construction Law Review 1995, pp. 65-68, adopts an even broader business management perspective and operates in nine phases: (a) establish objectives, (b) commitment – schedule, budget, philosophy, staffing; (c) scoping/objectives conference; (d) risk identification, (e) risk allocation, (f) integration, (g) implementation/ orientation, and (h) evaluation.

²² Cf. Luotonen, Eero, *Risk Management and Insurances*, Helsinki 1993, p. 18, who defines risk management as “... a comprehensive view of the risk factors threatening the business operations and at the same time a systematic course of action, which aims at minimising the likelihood of risks materialising and the economic losses caused by the risk.”

management is that the specific objectives of risk management are based on the business strategies with which the organization operates.²³

3.2 Future RM: Enterprise Risk Management?

The traditional perspective to RM has been under a continuous transformation due to relatively strong winds of change. Whereas the traditional RM has been promoted primarily by the



insurance and financial sectors, and developed further by the project management discipline, the recent winds of change come from quite different directions. An important source of thrust to the change has been the rise of the *corporate governance*-discipline and its focus on the monitoring of the business management of the organization. Another source for the winds of change has been the administrative implementation of corporate governance through *compliance* programs. This has been a particularly

important factor in the U.S. where a lot of the recent legal discussion on corporate governance has been focused on the compliance with the reporting requirements of the Sarbanes-Oxley Act (SOX).²⁴ The last but by far the least source of energy for the development of the RM discipline has been the rising interest towards *strategic thinking* in organizations.²⁵ Strategic thinking is increasingly being viewed as the most critical factor for the long-term success of organizations and has therefore managed to influence a wide range of business methods, including risk management. All these new ways of thinking have slowly but surely helped to transform the traditional insurance oriented risk management discipline towards a more holistic and versatile approach to risk management that is often addressed as Enterprise Risk Management (ERM).

What is ERM? Despite the availability of several international risk management standards – like the Australian/New Zealand Standard of AS/NZS 4360,²⁶ and the Federation of European Risk

²³ For an introduction to the various aspects of business strategies from the perspective of procurement. see Virolainen, Veli-Matti, *Motives, Circumstances, and Success Factors in Partnership Sourcing*, Lappeenranta University of Technology, Lappeenranta 1998, pp. 16-31, who has surveyed the partnership transacting practices and strategies of the Finnish telecommunication company Nokia.

²⁴ This force of change might not be enduring due to the increasingly critical theoretical and empirical studies on the effects of the SOX. For an eloquent summary of such studies see Ribstein, Larry, *Sarbanes-Oxley Act After Three Years*, Illinois Law and Economics Working Paper Series, Working Paper No. LE05-016, Draft June 20, 2005, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=746884.

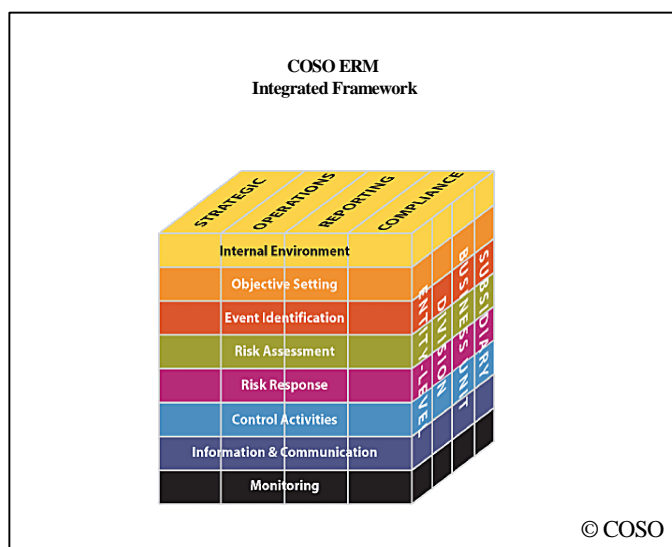
²⁵ For an excellent practical presentation of the relevance of strategic thinking in organizations see Freedman, Mike & Tregoe, Benjamin B., *The Art and Discipline of Strategic Leadership*, McGraw-Hill, New York 2003.

²⁶ The AS/NZS 4360 Standard was last reviewed in 2004 in order to to put greater emphasis the importance of embedding RM practices in the organization's culture and process, as well as on the management of potential gains as well as losses. The standard can be ordered at <http://www.riskinbusiness.com/>.

Management Associations (FERMA): A Risk Management Standard²⁷ - until quite recently there was no established standard definitions of the ERM. After the introduction of such definition by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)²⁸ in 2004, the development of ERM-standards is likely to accelerate. In the meantime, the COSO ERM – Integrated Framework²⁹ seems to be gaining growing popularity, as is shown in the findings of the second PriceWaterhouseCoopers’ benchmarking survey of ERM in Finland in 2006.³⁰ The COSO Framework is even being adopted within the public sector, at least in Finland, where the Ministry of Finance has used it as the platform for their framework for the internal revision and risk management of government agencies, institutions and funds.³¹ According to the COSO ERM – Integrated Framework:

”Enterprise risk management is a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”

One of the fundamental consequences of such an enterprise-wide focus is shift of the focus from negative risks to “events” that specifically underlines also the opportunity side of the risks. What divides the ERM-approach from the traditional RM-approach is the emphasis on the importance of four different objectives of risk management: the strategic, the operative, the reporting and the compliance. Naturally the strategic objective has been acknowledged by the more traditional RM standards,³² but not to the extent that the ERM-



²⁷ This standard is available at <http://www.ferma-asso.org/4-14.html>. This standard has been translated to 14 languages.

²⁸ COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance. COSO is sponsored by the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors (IIA), and the Institute of Management Accountants (IMA). For more information see <http://coso.org>.

²⁹ The COSO ERM Integrated Framework and other related information is available at <http://www.coso.org/publications.htm>.

³⁰ See PriceWaterhouseCoopers Finland, *Enterprise Risk Management (ERM) Benchmarking Survey 2006*, available at http://www.pwcglobal.com/fi/fin/about/svcs/neuvonta/erm_study_2006.pdf.

³¹ Information concerning this framework is available through the Internet both in Finnish http://www.vm.fi/vm/fi/03_tiedotteet_ja_puheet/01_tiedotteet/20051229Suosit/name.jsp and in Swedish http://www.vm.fi/vm/sv/03_pressmeddelanden_och_tal/01_pressmeddelanden/20051229Intern/name.jsp.

Unfortunately, the framework itself is (at least for the time being) available only in Finnish http://www.vm.fi/vm/fi/03_tiedotteet_ja_puheet/01_tiedotteet/20051229Suosit/98830.pdf.

³² The text of the AS/NZS 4360 Standard, should be read together with handbook to the AS/NZS 4360 Standard. *Risk Management Guidelines. Companion to AS/NZS 4360:2004*, Standards Australia International & Standards New Zealand, Sydney – Wellington 2004, where importance of the strategic perspective is pointed out more clearly.

approach emphasizes them by underlining that an effective ERM process must be applied within the context of strategy setting.³³

So what is in the framework? The COSO ERM Integrated Framework offers a quite ambitious conception of the role and perspectives of the RM in the governance of businesses as is clearly feasible through the COSO illustration of its framework that is featured in the figure. Accordingly, the COSO Framework relies on a three-way analysis based on the three dimensions of the ERM: the objectives (on top of the cube), organization (on side of the cube), and processes (on front of cube),

The four categories of the *objectives dimension* (on top of the cube) have already been mentioned: strategic, operative, reporting, and compliance. When it comes to the *organizational dimension* (on the side of the cube), COSO identifies four organizational levels: Subsidiary, Business unit, Division and Entity. Accordingly, the framework offers a highly detailed focus on the different areas of the risk management in an organization. Finally, when it comes to the ERM *processes dimension* (on the front of cube), the COSO ERM - Integrated Framework identifies eight interrelated components in ERM processes: Internal environment, Event identification, Risk assessment, Risk response, Control activities, Information and Communication, and Monitoring. Unfortunately, a detailed discussion on these dimensions and parts of the COSO ERM framework falls outside the scope of this paper. Such a discussion is found in the COSO *Enterprise Risk Management Integrated Framework – Executive Summary* (2004).³⁴

Although some recent surveys are pointing to the direction of a development towards a wider acceptance of the ERM as part of the best business practices, as will be discussed shortly, it remains to be seen if there will be a similarly wide acceptance for standardization of the ERM e.g. through the COSO ERM Intergrated Framework. Therefore, we should take a closer look at the current status of the risk management discipline.

3.3 Present RM

While the risk management discipline has departed its insurance focused past, the RM practice has not reached the future as described by e.g. the COSO ERM Intergrated Framework. What then is the present state of RM? What functions does RM have in organizations at the present? Due to the diversity of organizational cultures, it is naturally impossible to describe the present state in detail. However, some idea of what is going on in organizations is available through the identification of eventual regulation of RM activities in organizations, through benchmarking studies, as well as through a look at the various RM services and products that are available at the RM market. I will focus on the first two alternatives.

3.3.1 Regulation of RM activities

The most extensive legally binding regulation of RM activities of private companies is found in the U.S. Sarbanes-Oxley Act that imposes on companies a wide range of duties to report and inform its shareholders and the public of the status of the corporate governance within the

³³ See COSO's answer to question 1 under the chapter B of the *FAQs for COSO's Enterprise Risk Management – Integrated Framework* at http://www.coso.org/Publications/ERM/erm_faq.htm.

³⁴ The publication is available at http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf.

company. In comparison, there are only few European countries that have legally binding regulation of activities related to risk management, whereas legally non-binding regulations are found in the majority of European countries for the time being.³⁵ Nevertheless, the new EU Directive on statutory audits of annual accounts and consolidated account (2006/43/EC)³⁶ does *indirectly* imply that public-interest companies shall have risk management systems since according to article 41(2)(b) of the directive, audits committees of such companies shall:

“monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems”

Interestingly, no equivalent EU regulation exists for the time being on the public-interest companies' obligation to inform the public about such risk management systems. However, in its proposal for the amendment of Directives concerning the annual accounts of certain types of companies and consolidated accounts (COM 2004/0725), the EU Commission³⁷ proposes that listed EU companies shall include a corporate governance statement in their annual reports. EU commission proposes that such a statement shall, among other things, describe the company's internal control and risk management systems.³⁸ It is worth noticing that neither of these EU documents make any references to the existing standards within the field of risk management. For the time being, in most of the European countries, the RM activities have been left to the markets to regulate to the extent that they find it appropriate and most of the European markets have adopted regulations that function on the principle of “comply or explain”. In some European countries, particularly in the Nordic countries, RM is addressed as part of the corporate governance “codes”. For example in Denmark, the chapter VII of the revised Danish Recommendation for Corporate Governance³⁹ recommends that:

“VII. Risk management

Effective risk management is a prerequisite allowing the supervisory board to perform its tasks in the best possible way. Therefore, it is essential that the supervisory board arrange for appropriate

³⁵ For an introduction to and overview of the present state of regulation of internal control and risk management in European countries, see the Fédération des Experts Comptables Européens (The European Federation of Accountants), *Risk Management and Internal Control in the EU. Discussion Paper*. Marc 2005, available on-line at http://www.fee.be/publications/default.asp?library_ref=4&content_ref=351.

³⁶ Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, available on-line at <http://eur-lex.europa.eu/Notice.do?val=427746:cs&lang=en&list=429516:cs,427746:cs,&pos=2&page=1&nbl=2&pgs=10&hwords=2006/43/EC>.

³⁷ Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts (COM/2004/0725 final - COD 2004/0250), available on-line at http://eur-lex.europa.eu/LexUriServ/site/en/com/2004/com2004_0725en01.pdf.

³⁸ In its *Opinion of the European Economic and Social Committee on the Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts* (COM(2004) 725 final), available on-line at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/c_294/c_29420051125en00040006.pdf, the European Economic and Social Committee finds the wording of the Commissions proposal too wide and suggests the following wording for the article 46/a): “a description of the main features of the company's internal control and risk management system in relation to the financial reporting process”.

³⁹ The revised Danish Recommendation for Corporate Governance is available on-line in English at <http://www.corporategovernance.dk/index.php?obj=&code=1>.

risk management systems to be established and generally ensure that such systems meet the requirements of the company at any time

The purpose of risk management is to:

- develop and maintain an understanding of the organisation of the company's strategic and operational goals, including an identification of the critical success factors for achieving such goals.
- analyse the possibilities and challenges related to the implementation of the above goals as well as the risk of these goals not being met.
- analyse the most important activities launched by the company to identify the risks in this connection.
- determine the venture spirit of the company.

1. Identification of risks

The Committee *recommends* that the supervisory board and the executive board, when formulating the company's strategy and overall goals, identify the greatest business risks involved in achieving such strategy and goals.

2. Plan for risk management

The Committee ***recommends*** that the executive board prepare a plan for the company's risk management on the basis of the risks identified and submit this plan to the supervisory board for approval, and that the executive board regularly report to the supervisory board to allow the latter to systematically follow the trends in significant risk areas.

Comment: Such reporting may include procedures and action plans to eliminate, reduce, divide or accept these risks".

In comparison, according to the chapter 9.3 of *The Finnish Corporate Governance Recommendations for listed companies*⁴⁰ concerning the organization of risk management:

"Recommendation 50: The company shall describe the criteria according to which the risk management is organised.

Risk management is part of the control system of the company. The purpose of risk management is to ensure that the risks related to the business operations of the company are identified and monitored. Effective risk management requires definition of the risk management guidelines. For the evaluation of the operation of the company it is important to provide shareholders with sufficient information on risk management. It is also recommended that the significant risks that have come to the knowledge of the board are described."

Somewhat surprisingly, the *Stockholm Stock Exchange Corporate Governance Code* barely touches the matter of risk management by stating under the chapter 3.8.3 that "the audit committee is

⁴⁰ The Finnish Corporate Governance code is available in English at http://www.hex.com/files/4YqxkTEfR/liite/CG_Group_Recommendation_engl_final1.pdf.

to...meet regularly with the company's auditors to keep informed of the aims and scope of the audit work and to discuss...views on the company's risks."⁴¹ Similarly, the *Norwegian Code of Practice for Corporate Governance* only indirectly addresses risk management activities as the only reference to such activities is found in relation to board committees under the commentary to the recommendation 9 on the work of the board of directors. Remarkably, even here the Norwegian Code does not use the term risk management as it barely suggests that the duties of an audit committee typically include "...monitoring the company's internal control arrangements and its risk evaluation systems, as well as monitoring the internal audit function where this exists".⁴² As can be seen, these quite varied corporate governance codes do not provide detailed regulation of the risk management activities of organizations and make no reference to existing standards of risk management.

3.3.2 RM benchmarking studies

According to the findings of the recent European benchmarking study by the Federation of European Risk Management Associations (FERMA), *Risk Management: An Assessment of European in 2004*,⁴³ only 19 % of the respondent companies identified the measure of ratio between risks and opportunity as the main objective of the company's top risk management whereas 52 % focused on the avoidance of the negative side of risks. There are also strong signals of national RM cultures even within the Europe as French companies were more focused on insurable and operational risks and majority of French companies had not separated risk and insurance management, compared with British and German companies. However, the knowledge of risk management standards and frameworks was surprisingly low as only 41 % of all companies were familiar with the FERMA RM standard or other similar standards.

The findings of four recent benchmarking studies of the status of Enterprise Risk Management in Denmark,⁴⁴ Finland⁴⁵ and world-wide⁴⁶ by *PriceWaterhouseCoopers*, show a more optimistic picture of the current status of the ERM. Accordingly, 38 % of CEOs world-wide considered that their companies already had effective ERM in place and 46 % of CEO's believed that an ERM would be in place within one to three years. In comparison, in a study of the years 2005 and 2006 in Finland, 66 % of companies (up 11 % from the 2004 survey) considered that they had ERM processes and/or functions in place and another 30 % were considering adoption in

⁴¹ The Swedish Stock Exchange Corporate Governance code is available in English at <http://www.omxgroup.com/stockholmsborsen/en/index.aspx?lank=114>.

⁴² The Norwegian Code of Practice for Corporate Governance, 8 December 2005, p. 33. The Code is available on-line through <http://www.nues.no/English/>.

⁴³ The FERMA survey that was conducted in May to July 2004 is available at <http://www.ferma-asso.org/Calendar%20of%20events/Seminar%202004/Survey/RM%20Survey2004%20FERMA%20EY%20AXA%20-%202005oct2004.pdf>.

⁴⁴ This study that was conducted in April and May 2005 among the 100 largest Danish companies is available at <http://www.pwc.com/extweb/pwcpublications.nsf/docid/603DC44AFE80CAC5802570190046E683>.

⁴⁵ There are two benchmarking studies conducted in Finland: *Enterprise Risk Management Benchmarking Survey 2004*, available in English at http://www.pwcglobal.com/fi/fin/issues/publ/pwc_erm.pdf. The study results are based on the answers of 23 of the 60 largest companies in Finland, excluding financial institutions and insurance companies. A follow-up study conducted in 2005-2006 shows a further favorable development of ERM in Finland. See, *Enterprise Risk Management (ERM) Benchmarking Survey 2006*, available at http://www.pwcglobal.com/fi/fin/about/svcs/neuvonta/erm_study_2006.pdf.

⁴⁶ *7th Annual Global CEO Survey. Managing Risk: An Assessment of CEO Preparedness*, conducted in 2004 is available at <http://www.pwc.com/extweb/insights.nsf/docid/D4700640C39F9D6780256E1A00417F29>.

one to three years. The Finnish 2005-2006 study further shows that over 80 % of the Finnish companies considered ERM to have become part of good business practices (up 15 % from the 2004 survey)), which is further underlined by the fact that over 55 % of the Finnish companies in the 2004 study cited the company's reputation as a benefit of the ERM process. The most important finding of the Finnish studies is, however, the significant impact that the adoption of ERM has on the RM maturity⁴⁷ of the firm, particularly in the areas of event identification, monitoring and internal RM environment.⁴⁸ The national aspects of RM culture are feasible even in the Nordic setting since whereas over 85 % of the Finnish companies implied the corporate governance pressures to be an important motivation for the adoption of ERM according to the Finnish 2005-2006 study, only 33 % of Danish companies agreed with them in the Danish 2005 study. This difference can nevertheless partly be explained by the fact that the Finnish studies focused on public listed companies whereas in the Danish study such companies formed only a smaller part of the companies that were studied. The Danish study also shows the increasing importance of the strategic aspects of RM to organizations: 71 % of the Danish companies implied that assurance of whether the risk taking of the organization is in accordance with the organizations strategy was a function of the organization's RM activities, and 44 % of the Danish companies implied the increase of the likelihood that the organization meets its strategic goal as a function of RM. Based on these benchmarking studies it can reasonably be claimed that ERM is rapidly becoming an important part of good business practices.

4 Contracts and RM?

Despite the rapidly increasing appreciation of the perspectives of risk management in business management, literature dealing with the contract legal perspective of risk management is still rather limited.⁴⁹ The perspective of risk management is, however, nothing new to transaction lawyers, who will find it to be another label for their working method. The extent, consciousness, and depth of the contractual risk management-approach might nevertheless offer

⁴⁷ RM maturity was measured according to a ERM methodology developed by the PriceWaterhouseCoopers based on the self-assessments of the companies.

⁴⁸ The study also points out how the risk monitoring and the internal environment were the least developed areas of RM in Finnish companies.

⁴⁹ The original breakthrough for risk management within legal reasoning took place in construction contracts, where the idea of risk management has been frequently discussed since mid-1980's. See Abrahamson, Max W., *Risk Management*, International Construction Law Review 1984, pp. 241-264 as well as several other articles in the subsequent volumes of the *International Construction Law Review*.

In the past ten years the risk management approach to legal question has been gaining popularity even in the Nordic countries, particularly in Finland, where a number of books dealing with different aspects of legal risk management have been published during the past five years. Consider e.g. Keskitalo Petri, *From Assumptions to Risk Management*, Kauppakaari, Helsinki 2000; Pohjonen Soile (ed.), *Ennakoiva sopiminen*, WSOY Lakitieto, Helsinki 2002; Wahlgren Peter, *Juridisk riskanalys*, Jure, Stockholm 2003; Setälä Ilkka, et.al., *Yrityksen ja yhteisön vastuuriskit*, Tietosanoma Oy, Helsinki 2004; Iversen Jon, *Legal Risk Management*, Forlaget Thomson A/S, København 2004, which despite of its title is written in Danish; Haapio Helena, et.al., *Yritysten sopimus- ja vastuuketjut*, Tietosanoma, Helsinki 2005; Haapio Helena, et.al., *Yritysten sopimus- ja vastuuketjut*, Tietosanoma, Helsinki 2005; Hemmo Mika, *Sopimusoikeus III*, Talentum, Jyväskylä 2005; and Trzaskowski Jan, *Legal Risk Management in Electronic Commerce*, Ex Tuto Publishing, Copenhagen 2005, available on-line at <http://www.legalriskmanagement.net/>. The latest addition to such literature is the volume 49 of the *Scandinavian Studies in Law*, dedicated to the subject of *Proactive Approach*.

A broader legal perspective to risk management is found in Baldwin, Robert (ed.), *Law and Uncertainty: Risks and Legal Processes*, 1997 and Steele, Jenny, *Risks and legal theory*, Hart, Oxford 2004.

some insights even for the most experienced transaction lawyers, who in *Erich Schanze's* terms have "... large contract files ... [and] anecdotal knowledge on the emergence and survival of numerous individual transactions, and they have developed a sense of whether a specific micro or macro structure of institutional design may be transferred into a different commercial context."⁵⁰

What then is the relationship between contracts and risk management? What kind of a role can contracts and contracting play in the organization's risk management? Due to the different functions of risk management, even the answers to these two questions will vary from an organization to another, as well as from one person to another. Accordingly, even if we were to agree that good contracts are an essential asset to the organization, we would most likely have different expectations and different views of what good contracts are and what functions the contracting has for the organization.

Contracting can therefore have different functions within the different interest groups in an organization. From the business administration perspective contracting might be associated with contract administration, whereas business governance perspective would see contracting as a tool for strategic management. A legal management perspective might lead us to associate contracting as a tool for compliance and a risk management perspective might see contracting as a tool for risk treatment.

In addition, contracts and contracting can have quite different roles as part of the different risk management strategies of organizations. This is illustrated in the following table, which presents a *caricatural* picture of an eventual line of evolution in the role of contracts and lawyers as part of the risk management activities of an organization, which follows the line of evolution of the organizations risk management strategy as described by *Suominen*,⁵¹ supplied with the last strategy category: the ERM.

⁵⁰ Schanze, Erich, *Legalism, Economism, and Professional Attitudes Towards Institutional Design*, Journal of Institutional and Theoretical Economics 1993, p. 130, describing the method of "better" consultants.

⁵¹ See Suominen, Arto, *Riskienhallinnan mahdollisuudet ja kehityshaasteet*, in Kuusela, Hannu & Ollikainen, reijo, *Riskit ja riskienhallinta*, Tampere University Press, Vammala 1999, pp. 137-142.

RM-strategy	RM-role contracts	of Role contracts	of Role contracting	of Focus contracting	Lawyers role	Responsibility for contracting
Luck	<i>Unstructured</i>	Contract = risk!	<i>Legal</i>	Documentation	<i>"Plague"</i>	Lawyer?
Insurance focused	<i>Unstructured</i>	Contract risks?	<i>Legal</i>	Documentation	<i>Filing clerk?</i>	Lawyer?
Risk aware	<i>Ad hoc</i>	Contract risks!	<i>Tool for business management?</i>	Operational contract planning	<i>Expert</i>	Lawyer/ in-house lawyer
Versatile	<i>Ad hoc/ systematic</i>	Contracts & RM?	<i>Tool for business management!</i>	planning and administration (and strategic management of contracting?)	<i>Counselor</i>	In-house lawyer
ERM	<i>Systematic and integrated</i>	Contractual ERM!	<i>Tool for business governance!</i>	Strategic, operational, reporting and compliance of management of contracting	<i>Team player</i>	Chief Contracting Officer

All these different functions need to be addressed and integrated in a conceptualization of the interplay between contracts and risk management. How this is actually done depends on the chosen conceptualization of the role of contract in this interplay and the focus point in the management of contracting. In the following, I will discuss a few alternative approaches for the conceptualization of the relationship between contracts and risk management, namely: proactive contracting, contract administration, contract management, enterprise contract management and eventual alternatives beyond such conceptualizations.

4.1. *Proactive contracting*

Proactive contracting represents a conceptualization of the relationship between contracts and risk management in a way that focuses first and foremost on the creation of contracts. Accordingly, a major portion of the early literature on proactive contracting focuses on the creation of good contracts, which are synonymous to proactive contracts. Proactive contracts are then understood as tools for managing the goals of the transactions as well as the expectations embedded to them. Such proactive contracting presupposes that any false assumptions and unrealistic expectations can be prevented by the use of the proactive approach, which presupposes that the contract parties know *why* and *when* to contract, *what about* and *what* they contract for, as well as *what* they have *not* specifically contracted for but which is *regulated by the default legal norms* that will apply to the contract unless the contract contains contracts terms that alter these norms, to the extent that that is allowed by the legal norms that apply to the contract.

Such a primary focus within the early proactive contracting literature on the creation of contracts is a less than optimal conceptualization of the relationship between contracts and risk management since it has an unclear approach to the strategic perspective of risk management. Furthermore, it does not pay due attention to the elementary nature of effective risk management as a disciplined process that starts already before the creation of the contracts and continues thereafter.

4.2 *Contract Administration and RM*

Contract administration is a discipline that is particularly popular in public sector contracting and refers to the administration of contracts after that they have been signed.⁵² This focus on the implementation of contracts is another way to conceptualize the relationship between contracts and risk management. Contract administration-discipline is strongly influenced by the project management-discipline but has a more narrow focus due to the focus on implementation of contracts, whereas project management-discipline focuses on the entire life-cycle of a project. Accordingly, contract administration concentrates on the implementation of (single) transactions, which is less than optimal considering the recent development of risk management discipline towards a more holistic governance and strategy oriented Enterprise Risk Management. Nevertheless, contract administration-discipline reminds us of the importance of the implementation of contracts after that they have been created, which is a very important lesson for contracting.

⁵² Compare though Boyce, *Successful Contract Administration*, Hawsmere, London 1992, who uses the term contract administration in a broader sense that covers even the contract creation. Such use of the terminology seems however unusual in recent contracting literature.

4.3 *Contract Management and RM*

Contract Management is sometimes used as a synonym to contract administration but such language is insensitive to the fact that the contract management-discipline has shifted its focus from the contract implementation to contract lifecycle management. Accordingly, contract management refers to the processes of managing the entire lifecycle of contracts. Contract management as a discipline has existed in the U.S. since the 1950's and the oldest association of contract managers, The National Contract Manager Association (NCMA) was established as early as 1959.⁵³ NCMA has published two journals: *Contract Management Magazine*⁵⁴ since 1977 and *The Journal of Contract Management*⁵⁵ since 2002. Although the contract manager profession is not new, it did not receive appropriate attention outside the U.S. before the 1990's. The increasing status of this profession is reflected in the establishment of the first international association of contract managers, The International Association for Contract and Commercial Management (IACCM) in 1993.⁵⁶ Both of these associations offer a wide-range of on-site and on-line education and certification services for contract professionals. The status of contract management-discipline and the profession of contract managers is likely to increase extensively particularly in the U.S. due to the new corporate control pressures in the aftermath of the Sarbanes-Oxley Act of 2002.

Although the contract management discipline is focused on the management of contracts through their entire lifecycle, there are other challenges in its relationship to risk management. Contract management discipline seems to share the traditional focus on contract risks rather than business risks. It also seems that contract management is focused on the management of single contracts, or to be more precise on single transactions. From the perspective of the current trends in risk management such a focus is not optimal since effective management of business demands focus on the governance of the entire enterprise.

4.4 *Enterprise Contract Management and RM*

As suggested earlier, the contract management discipline is under development towards something that is often called Enterprise Contract Management (ECM) that focuses on the organization's entire contracting activity. This trend is first and foremost visible through and driven by the introduction of Enterprise Contract Management IT-systems. Such a development is not surprising considering the practical problems that many organizations face in managing their contract portfolios and these problems are not about to diminish as many companies are outsourcing increasingly larger areas of their traditional business activities.⁵⁷ According to a benchmarking study among over 100 of the Forbes Global 2000 companies in

⁵³ Information of the NCMA is available at <http://www.ncmahq.org/>.

⁵⁴ Information concerning this journal is available at <http://www.ncmahq.org/publications/cm/>.

⁵⁵ Information concerning this journal is available at <http://www.ncmahq.org/publications/jcm.asp>.

⁵⁶ Information of the IACCM is available at <http://www.iaccm.com>.

⁵⁷ According to the U.S. National Association of Purchasing Managers, an average Fortune 1000 company has between 20.000 and 40.000 contracts, see Krappé & Kallayil, *Contract Management Is More out of Control Than You Think*, *Journal of Contract Management* 2003, p. 4, available on-line at <http://www.iaccm.com/forum/articles/JCMApr03article.pdf>.

2003,⁵⁸ the state of contract management in some of the world's largest companies is at an alarming level.⁵⁹ According to the findings of this study:

- 81 % of companies had problems finding contracts,
- 20 % of companies said 10 % or more of their contracts may not be located at all,
- 33 % of companies stored contracts in more than 10 locations,
- 34 % of companies had no risk evaluation process before signing contracts,
- 52 % of companies did not know the expiration date of all their contracts, while 43 % of companies had more than 20 % of their contracts renewed automatically, thereby missing the opportunity to review the contract terms.

ECM IT-systems offer highly efficient platforms for a truly professional management of such practical problems, particularly in organizations that have hundreds and even thousands of contracts with their suppliers and customers. Analysts claim that ECM IT-systems fill a gap between the existing management IT-systems like Enterprise Resource Planning (ERP), Customer Relationship Management (CRM) and Supplier Relationship Management (SRM) that includes Supply Chain, Procurement and Sourcing Management, despite the effort of the vendors of such systems to cover even the contract management issues.⁶⁰ The reason for the effectiveness of ECM IT-systems is claimed to be their focus on the enterprise-wide approach, and the fact that an ECM IT-system can (and should) communicate with the ERP, CRM and SRM IT-systems.

Independent industry analysts generally believe that ECM IT-systems can dramatically improve organization's economic performance. *Accenture* believes that an organization can reduce procurement expenses with 3-5 %, reduce manual work efforts related to contract negotiation and management by 50-75 %, and increase net revenue through the avoidance of tens or hundreds of millions of dollars in increased contract liabilities.⁶¹ *Aberdeen Group* estimates e.g. 25-30 % reductions in administration costs and 55 % improvement in compliance management.⁶² If these estimations of the economic benefits of ECM IT-systems are even close to reality, all organizations should seriously look into the possibilities and needs to implement such ECM IT-systems. There are quite a few vendors of ECM IT-systems both in North America and in Europe but there are also guides to the choice of an ECM vendor.⁶³ The market for ECM IT-products is expanding at a very high speed and *AberdeenGroup* estimates that the market for licences alone will top 351 million U.S. dollars in 2005 and continue to grow with

⁵⁸ The *Forbes Global 2000* list quotes every year the world's 2000 largest companies. Information concerning year 2005 Global 2000 list is available at <http://www.forbes.com/2005/03/30/05f2000land.html>.

⁵⁹ See Krappé & Kallayil, *Contract Management Is More out of Control Than You Think*, *Journal of Contract Management* 2003, pp. 3-8, available at <http://www.iaccm.com/forum/articles/JCMApr03article.pdf>.

⁶⁰ See *Accenture*, *Managing contracts to increase revenue and profits*, white paper, 2002, p. 15-16, available at http://www.accenture.com/Global/Research_and_Insights/By_Industry/Health_and_Life_Sciences/Pharmaceuticals_and_Medical_Products/ManagingProfits.htm.

⁶¹ *Accenture*, *Managing contracts to increase revenue and profits*, white paper, 2002, p. 20, available at http://www.accenture.com/Global/Research_and_Insights/By_Industry/Health_and_Life_Sciences/Pharmaceuticals_and_Medical_Products/ManagingProfits.htm.

⁶² *AberdeenGroup*, *The Contract Management Solution Selection Report*, June 2005, available through http://www.aberdeen.com/summary/report/benchmark/RA_CMSolSelect_TM.asp. The estimates of this report are based on benchmarking studies of more than 300 companies.

⁶³ See e.g. the aforementioned report by the *AberdeenGroup* and the *IACCM* list of recommended vendors at <http://www.iaccm.com/forum/vendors.php>.

20 % yearly rate through 2008,⁶⁴ which tells us something about the current demand for such systems.

Although such ECM IT-systems can greatly enhance the contract management of an organization, they are only systems facilitating the actual enterprise contract management. Accordingly, the persons responsible for the contracting activities of organizations still need to be trained in order to have the knowledge and skills needed to manage contracts and risks. Further, the ease of use of the ECM IT-systems should not distract the organizations attention from the fact that they still need to develop the necessary contract management *know-how*, particularly the strategic contract management know-how in order to enable the organization to fully exploit the opportunities in ECM IT-systems. One aspect of such know-how is the need to differentiate between the levels of contract management expertise that are needed at different levels of contracting.

At the same time the ECM IT-systems also offer an opportunity to develop the role of corporate counsels, although that development comes at the price of an update of the IT-skills of corporate counsels.⁶⁵ Accordingly, the most advanced IT-systems will enable retrieval of records on previous contract negotiations and data on how those contracts have performed, what types of contracts have worked and what have not, to quickly collect specific transactional data in order to determine whether contractual obligations have been complied, and to pull out reports for auditing activities. Such data retrieval necessarily demands certain skills but first and foremost it demands a clear understanding of the kind of a data that the system can provide and how that data can be used for analysis of the contract portfolio of the organization.

Despite the enterprise-wide focus there seems to be little focus on the strategy side of contracting. Accordingly, the enterprise functions of ECM IT-systems seem to focus on the different analytic functions of the systems, whereas one would expect a stronger focus of the strategic management of such IT-systems. Such shortcomings can, however, be remedied through active management and analysis of the information provided by such systems.

Naturally, the enterprise contract management need not rely on any IT-system which will have decreasing added value in small companies that have clear visibility of their contracts. The functions that such IT-systems have to offer should though be of interest particularly to companies that operate manual enterprise contract management systems.

4.5 *Beyond Enterprise Contract Management?*

As we have seen, there are many different ways to conceptualize the relationship between contracts and risk management. And still, these alternatives have only to a small degree put emphasis on risk management. If enterprise risk management is going to achieve the position that the new ERM-standards are describing, such a lack of focus on risk management will represent a challenge for the development of contracting towards such an enterprise-wide risk management approach. A stronger emphasis on risk management and particularly on enterprise

⁶⁴ See AberdeenGroup, *The Contract Management Solution Selection Report*, June 2005, available through http://www.aberdeen.com/summary/report/benchmark/RA_CMSolSelect_TM.asp.

⁶⁵ For a more detailed discussion see I-many Inc., *Contract Management Solutions and its Impact on the Role of Corporate Counsel*. White paper, available at http://www.iaccm.com/forum/articles/contractmanagement_law.pdf.

risk management could namely bring on fundamental changes: shift of focus from the contract risk towards contractual management of all kinds of risks and separation of at least the strategic and operative aspects to the enterprise-wide use of contracts in risk management. An attempt to integrate such risk management perspectives with the enterprise contract management approach is the central theme for the next chapter.

5 Contractual Enterprise Risk Management (C-ERM)

My approach to conceptualization of the interplay between contracts, risks and management is based on the integration of legal, economic and risk management perspectives to this matter. Whereas my original theory of contractual risk management (C-RM), presented in my doctoral thesis in 2000, was focused on the theoretical foundations for the creation of risk managing proactive contracts,⁶⁶ the operative models of strategic and operative C-RM, which I developed in a paper published in 2002,⁶⁷ were the first steps in adjusting my original theory to the strategical needs of the enterprise-wide governance of contracts and to the operative needs of the management of contracts. These adjustments have now led to the formulation of a theory of *Contractual Enterprise Risk Management (C-ERM)* that addresses the management of *all types of risks* to an organization with help of governance and management of the contracting activities of the entire organization. In this adjusted theory, the enterprise contract management and enterprise risk management approaches have become fully integrated to my original contractual risk management approach. In the remaining pages of this paper I will only shortly present the framework for C-ERM, focusing on its concepts and structures. Hopefully I will be able to publish a more detailed presentation of C-ERM by the end of 2007 in a book format. In the meantime, more information about C-ERM and other related information on the interdisciplinary interplay between contracts, risks and management will be made available through the *Monitor of Contractual Risk Management (MCoRiM)* at www.mcorim.com, which is a web-portal that will be launched during the end of 2006.

5.1 Goals of C-ERM

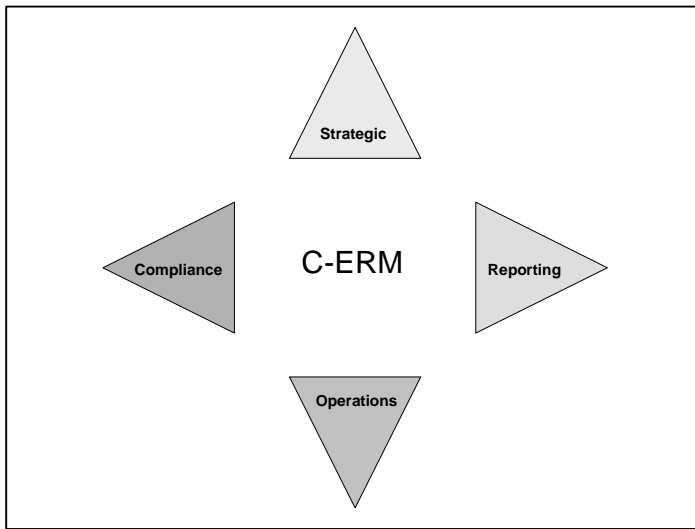
The goals of the C-ERM are established under general ERM. This external point of departure for the C-ERM is the reason why the concept 'contractual enterprise risk management' was chosen as the name for the contract legal perspective to risk management, instead of the concept 'contractual enterprise management'. However, C-ERM can offer some insights for the general ERM particularly in the phases of risk analysis and risk evaluation.

⁶⁶ See Keskitalo, Petri, *From Assumption to Risk Management*, Kauppakaari, Helsinki 2000. Summary of this book is available at my homepage at:

http://www.jus.uit.no/ansatte/keskitalo/SUMMARY_of_%20PROJECT.htm.

⁶⁷ See Keskitalo, Petri, *Sopimuksellisen riskienhallinnan teoria ja toimintamallit*, in Pohjonen, Soile (ed.), *Ennakoiva sopiminen*, WSOY Lakitieto, Helsinki 2002, pp. 241-273.

5.2 Structure of C-ERM



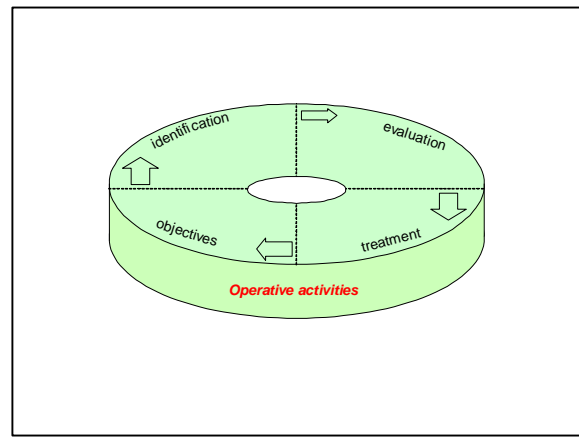
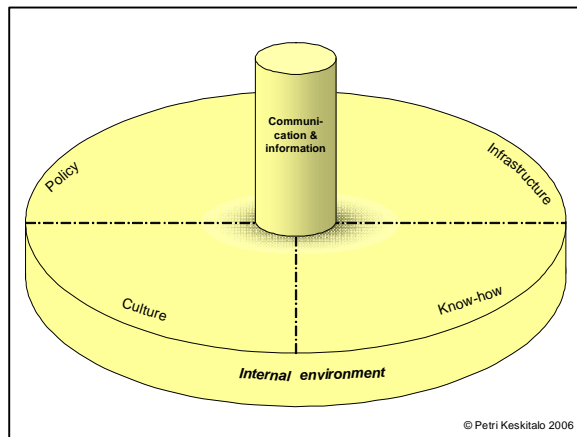
C-ERM adopts the philosophy of ERM but focuses on the enterprise's contracting activities as *tools* for risk management. Similarly to the COSO ERM Integrated Framework's approach to risk management, C-ERM separates between the strategic, operations, reporting, and compliance *fields* of the contracting activities of an organization. However, under the field of C-ERM operations it also applies the CRM processes and separation between the phases of creation, administration and monitoring of contracts.

Although the C-ERM separation of four fields of contracting is similar to the division between four “categories of objectives” within the COSO ERM Integrated Framework, my definition of the Contractual-ERM does not share the structure of COSO ERM Integrated Framework. Accordingly, instead of the visualization of eight “components” of the COSO ERM Integrated Framework, Contractual-ERM is based on a more analytical approach that identifies *three levels of management* that are built upon and linked to one another:

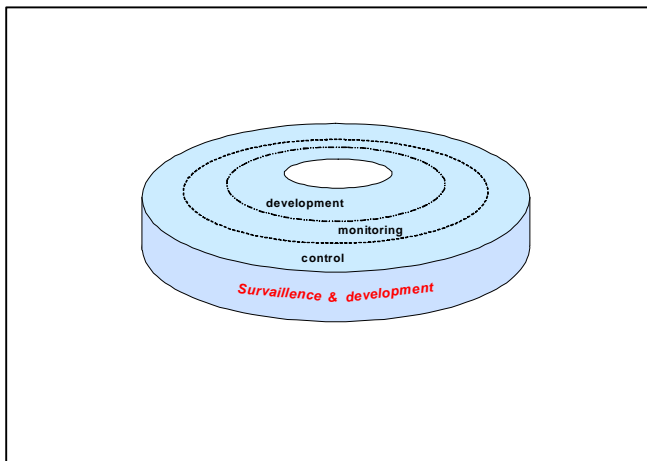
- Internal environment,
- Operative activities, and
- Surveillance & development

This three-level structure is shared by all of the four fields of C-ERM.

The level of *internal environment* forms the fundament of each of the four fields of C-ERM. These internal environments consist of five areas: culture, policy, infrastructure, know-how, and finally, communication & information, an area that functions as the link between the three levels of management. The central role of this area is underlined in the illustration through the visualization of it as a pole in the centre of this level. All these five areas deal with several issues within their subject areas e.g. infrastructure addresses the matters of organization, resources and tools of management.

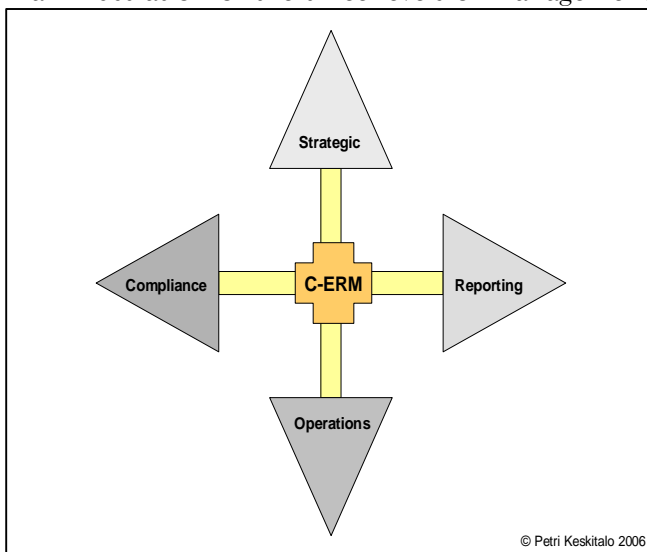


The level of *operative activities* is built upon the level of internal environment of management. The operative activities are divided into four areas: objective setting, event identification, event evaluation, and event treatment. These represent the traditional core of risk management activities and form therefore the midlevel in the structure of all of the four fields of C-ERM.



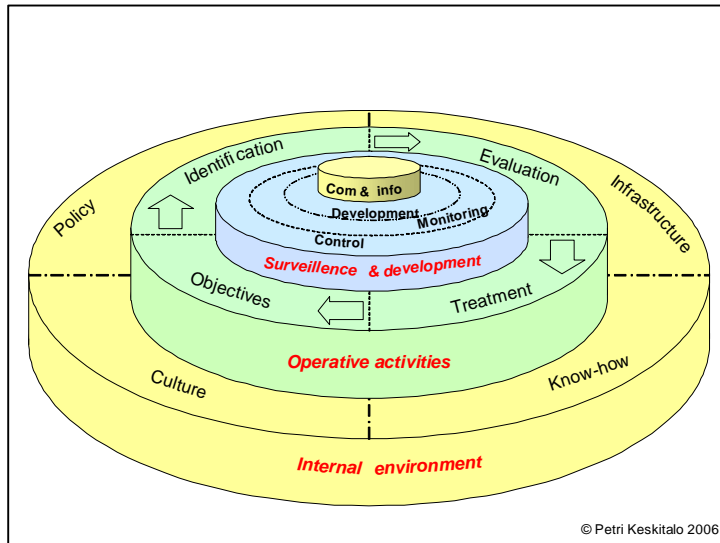
The level of *surveillance & development* is built upon the lower levels of management and focuses on the surveillance and development of all of the three levels of management. Even this level of management is divided into areas: control, monitoring and development.

role of the management of communication and information can be visualized with the help of an illustration of the three levels of management as parts of a traditional children's toy: a stack



How do all these three *levels* hang together? As suggested earlier, it is the management of communication and information concerning the contracting activities of organization that does the job. This central role of the management of communication and information can be visualized with the help of an illustration of the three levels of management as parts of a traditional children's toy: a stack pile, where the different pieces are kept in their place by a pole in the center of the fundament. However, the role of the communication and information is even more central when one considers the cooperation between the four *fields* of C-ERM: the strategic, operational, reporting and compliance perspectives to C-ERM. Communication and information between these fields is namely an elementary condition for the effectiveness of Contractual Enterprise Risk Management. Therefore the internal communication and information concerning the organizations contracting activities links not only the

different levels of management within each of these fields of C-ERM but in addition it also



links the four fields of management to one another.

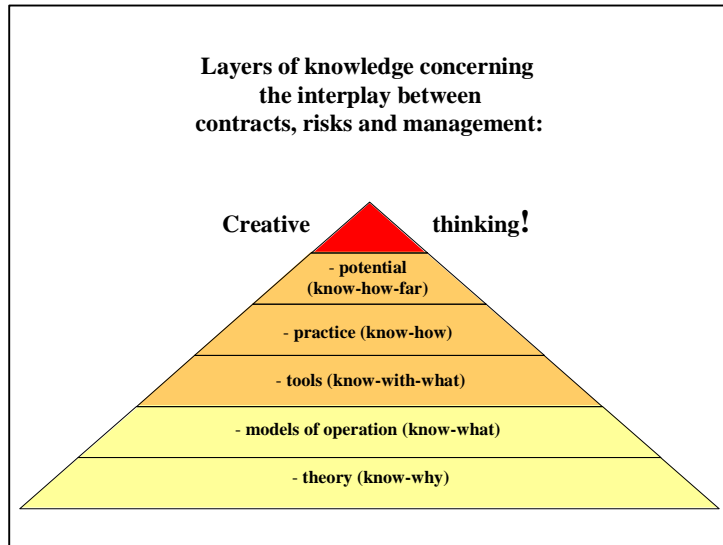
Such effective management of communication and information concerning the organization's contracting activities presupposes that someone within the organization has responsibility for the coordination of these fields of C-ERM. Due to the complex structure of contracting in many organizations, the relocation of all contracting activity to a separate contracting unit or division is not

desirable. A more fruitful solution is most likely found through focus on the organization of the coordinating tasks. Depending on the size of the organization this could be a person, a group of persons or a council with top executive representatives from all of the divisions of the organization that are engaged in contracting activities.⁶⁸ Whereas the organizational form of this coordinative task is less important, the assignment of the coordinative responsibility in itself is crucially important and should be the starting point for a development of Contractual Enterprise Risk Management in organizations. From thereon the organizations can focus on the four fields of management, one at a time, developing the fields and levels of management and management areas therein according to the needs of the organization. Such a development should be able to fully integrate and transform the existing contract administration, contract management and enterprise contract management disciplines, and even the Governance, Risk and Compliance Management (GRC) activities within the organization into the C-ERM system. The road of such implementation of C-ERM is long and challenging but the reward of having a developed a disciplined and organized contracting activity that is updated to meet the challenges of the Enterprise Risk Management should be rewarding.

6 Beyond knowledge and skills

At the end of our journey it is time to return to the illustration of the different layers of knowledge on the interplay between contracts, risks, and management as a pyramid with its structural implications. As suggested in the beginning of this paper, I have discussed the two elementary layers of such a pyramid of knowledge and only shortly touched upon the mid-layers of knowledge of and skills for the interplay contracts, risk and management, leaving these more pragmatic layers to be studied with help of the increasingly broader literature on contracting.

⁶⁸ Creation of such a contract management governance council is one of the ten practical recommendations of the Aberdeen Group in their benchmarking report, written by Minahan, Tim A., *Best Practices in Contract Management. Strategies for Optimizing Business Relationships*, Aberdeen Group September 2004.



Now it is time to return to my promise to reveal the very top of the pyramid that actually is not about knowledge or skills. What the top of the pyramid stands for is the *art* of creative thinking. The ability for creative application of the different layers of knowledge according to the needs and resources of the organization is the actual key to a successful implementation of the contractual risk management. At the same time, such creative thinking is difficult to learn through reading and is most effectively learned by

doing; through attempts and mistakes. Fortunately, the number of obvious mistakes can be narrowed down through the study of unsuccessful contractual risk management that can be found all around us and which is particularly visible in case law concerning contracting; contracts that end up in courts can namely be assumed to have failed, at least for one of the contract parties. Another source for stories, stories with happier endings in contractual risk management, is benchmarking studies that are becoming increasingly popular. The dilemma in such studies is that due to their case study nature, the lessons to be learned might not be the right lessons for other organizations. A more comprehensive source of knowledge can be found in the empirical studies conducted under the academic discipline of Law, Economics & Organization also known as the Transaction Cost Economics that offers a great potential for the development of all the levels of knowledge concerning the interplay between contracts, risks and management. And still, at the end of day, the key to truly successful contractual risk management – the cutting edge – lies in the *creative* minds of those in charge of the organizations contracting activity.

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